

(2) The sum of the shareholder's pro rata shares of all items of deduction and loss of the corporation for the taxable year.

(iii) *Proration of deductions disallowed under at-risk limitation.* If any amount of the taxpayer's loss from an activity (within the meaning of section 465(c)) is disallowed under section 465 for the taxable year, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(I) The amount of the loss from the activity that is disallowed for the taxable year; by

(2) The sum of all deductions from the activity for the taxable year.

(iv) *Coordination of basis and at-risk limitations.* The portion of any item of deduction or loss that is disallowed for the taxable year under section 704(d) or 1366(d) is not taken into account for the taxable year in determining the loss from an activity (within the meaning of section 465(c)) for purposes of applying section 465.

(v) *Separately identified items of deduction and loss.* In identifying the items of deduction and loss from an activity that are not disallowed under sections 704(d), 1366(d), and 465 (and that therefore may be treated as passive activity deductions), the taxpayer need not account separately for any item of deduction or loss unless such item may, if separately taken into account, result in an income tax liability different from that which would result were such item of deduction or loss taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Items of deduction or loss that must be accounted for separately include (but are not limited to) items of deduction or loss that—

(A) Are attributable to separate activities (within the meaning of the rules to be contained in § 1.469-4T);

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the

taxpayer activity participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(C) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(D) Arose in a taxable year beginning before 1987 and were not allowed for such taxable year under section 704(d), 1366(d), or 465(a)(2);

(E) [Reserved] See § 1.469-2(d)(6)(v)(E) for rules relating to this paragraph.

(F) Are attributable to pre-enactment interests in activities (within the meaning of § 1.469-11T(c)).

(7) *Deductions from section 481 adjustment—(i) In general.* If a change in accounting method results in a negative section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (d)(7)(iii) of this section) of the amount taken into account for a taxable year as a net negative section 481 adjustment by reason of such change shall be treated as a deduction from the activity for such taxable year, and such deduction shall be treated as a passive activity deduction if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)). See the rules to be contained in § 1.469-1T(k) for the treatment of passive activity deductions from an activity in taxable years in which the activity is a former passive activity.

(ii) *Negative section 481 adjustments.* For purposes of applying this paragraph (d)(7)—

(A) The term “net negative section 481 adjustment” means the decrease (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term “negative section 481 adjustment with respect to an activity” means the decrease (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of

amounts from such activity by reason of the change in accounting method.

(iii) *Ratable portion.* The ratable portion of the amount taken into account as a net negative section 481 adjustments for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The negative section 481 adjustment with respect to the activity; by

(B) The sum of the negative section 481 adjustments with respect to all of the activities of the taxpayer.

(8) *Taxable year in which item arises.* [Reserved] See § 1.469-2(d)(8) for rules relating to this paragraph.

(e) *Special rules for partners and S corporation shareholders—*(1) *In general.* For purposes of section 469 and the regulations thereunder, the character (as an item of passive activity gross income or passive activity deduction) of each item of gross income and deduction allocated to a taxpayer from a partnership or S corporation (a “pass-through entity”) shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in the activity (or activities) that generated such item. Such participation is determined for the taxable year of the passthrough entity (and not the taxable year of the taxpayer). The following example illustrates the application of this paragraph (e)(1):

*Example.* A, a calendar year individual, is a partner in a partnership that has a taxable year ending January 31. During its taxable year ending on January 31, 1988, the partnership engages in a single trade or business activity. For the period from February 1, 1987, through January 31, 1988, A does not materially participate in this activity. In A's calendar year 1988 return, A's distributive share of the partnership's gross income and deductions from the activity must be treated as passive activity gross income and passive activity deductions, without regard to A's participation in the activity from February 1, 1988, through December 31, 1988. See also § 1.469-11T(a)(4) (relating to the effective date of, and transition rules under, section 469 and the regulations thereunder).

(2) *Payments under sections 707(a), 707(c), and 736(b).* Items of gross income and deduction attributable to a transaction described in section 707(a),

707(c), or 736(b) shall be characterized for purposes of section 469 and the regulations thereunder in accordance with the following rules:

(i) *Section 707(a).* Any item of gross income or deduction attributable to a transaction that is treated under section 707(a) as a transaction between a partnership and a partner acting in a capacity other than as a member of such partnership shall be characterized for purposes of section 469 and the regulations thereunder in a manner that is consistent with the treatment of such transaction under section 707(a).

(ii) *Section 707(c).* [Reserved] See § 1.469-2(e)(ii) for rules relating to this paragraph.

(iii) *Payments in liquidation of a partner's interest in partnership property.* [Reserved] See § 1.469-2(e)(iii) for rules relating to this paragraph.

(3) *Sale or exchange of interest in passthrough entity—*(i) *Application of this paragraph (e)(3).* In the case of the sale, exchange, or other disposition (a “disposition”) of an interest in a passthrough entity, the amount of the seller's gain or loss from each activity in which such entity has an interest is determined, for purposes of section 469 and the regulations thereunder, under this paragraph (e)(3). In the case of any such disposition, except as otherwise provided in paragraph (e)(3)(iii) or (iv) of this section, paragraph (e)(3)(ii) of this section shall apply. See paragraphs (c)(2) and (d)(5) of this section for rules for determining the character of gain or loss, respectively, recognized upon a disposition of an interest in an activity held through a passthrough entity.

(ii) *General rule—*(A) *Allocation among activities.* Except as otherwise provided in this paragraph (e)(3)(ii) or in paragraph (e)(3)(iii) or (iv) of this section, if a holder of an interest in a passthrough entity disposes of such interest, a ratable portion (within the meaning of paragraph (e)(3)(ii)(B) of this section) of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which such passthrough entity owns an interest on the applicable valuation date.

(B) *Ratable portion*—(1) *Dispositions on which gain is recognized.* The ratable portion of any gain from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such gain by the fraction obtained by dividing—

(i) The amount of net gain (within the meaning of paragraph (e)(3)(ii)(E)(3) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(ii) The sum of the amounts of net gain that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each appreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(1) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(2) *Dispositions on which loss is recognized.* The ratable portion of any loss from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such loss by the fraction obtained by dividing—

(i) The amount of net loss (within the meaning of paragraph (e)(3)(ii)(E)(4) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(ii) The sum of the amounts of net loss that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each depreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(2) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(C) *Default rule.* If the gain or loss recognized upon the disposition of an

interest in a passthrough entity cannot be allocated under paragraph (e)(3)(ii)(A) of this section, such gain or loss shall be allocated among the activities described in paragraph (e)(3)(ii)(A) of this section in proportion to the respective fair market values of the passthrough entity's interests in such activities at the applicable valuation date, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity.

(D) *Special rules.* For purposes of this paragraph (e)(3)(ii), the following rules shall apply:

(1) *Applicable valuation date*—(i) *In general.* Except as otherwise provided in paragraph (e)(3)(ii)(D)(1)(ii) of this section, the applicable valuation date with respect to any disposition of an interest in a passthrough entity is whichever one of the following dates is selected by the passthrough entity:

(a) The beginning of the taxable year of the passthrough entity in which such disposition occurs; or

(b) The date on which such disposition occurs.

(ii) *Exception.* If, after the beginning of a passthrough entity's taxable year in which a holder's disposition of an interest in such passthrough entity occurs and before the time of such disposition—

(a) The passthrough entity disposes of more than 10 percent of its interest (by value as of the beginning of such taxable year) in any activity;

(b) More than 10 percent of the property (by value as of the beginning of such taxable year) used in any activity of the passthrough entity is disposed of; or

(c) The holder of such interest contributes to the passthrough entity substantially appreciated property or substantially depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the passthrough entity as of the beginning of such taxable year;

then the applicable valuation date shall be the date immediately preceding the date on which such disposition occurs.